Washington State Auditor's Office

Financial Statements and Actuarial Reviews
Audit Report

Worker's Compensation Program

Audit Period
July 1, 2009 through June 30, 2010

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WASHINGTON
BRIAN SONNTAG
STATE AUDITOR

Washington State Auditor
Brian Sonntag

December 30, 2010

The Honorable Christine Gregoire, Governor
The Honorable Karen Fraser, Senate Democratic Caucus Chair
The Honorable Linda Evans Parlette, Senate Republican Caucus Chair
The Honorable Dawn Morrell, House Democratic Caucus Chair
The Honorable Dan Kristiansen, House Republican Caucus Chair
Marty Brown, Director, Office of Financial Management
Judy Schurke, Director, Department of Labor and Industries

Report on Actuarial Reviews and Financial Statement Audit

Please find attached our report on the Worker's Compensation Program actuarial reviews and financial statement audit as required by state law (RCW 51.44.115).

Sincerely,

BRIAN SONNTAG, CGFM
STATE AUDITOR

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Description of the Worker's Compensation Program

State of Washington
Worker's Compensation Program

AUDIT AUTHORITY

State law (RCW 51.44.115) requires the State Auditor's Office to annually audit and report on the financial statements of the Workers' Compensation Program administered by the state Department of Labor and Industries. The law also requires us to contract with independent actuaries to obtain actuarial assessments and opinions on the accounts. This is our fifth audit of the program.

RESULTS IN BRIEF

- The financial statements for the Workers' Compensation Program for fiscal year ended June 30, 2010, were fairly presented in accordance with generally accepted accounting principles.
- Reported loss and loss adjustment expense reserves are reasonable.
- The Accident Account is insolvent and the proposed rate increase will not be sufficient to restore the contingency reserve and maintain the solvency of the account over the next five years.
- The proposed rate decrease for the Medical Aid Account will likely be inadequate to allow the Medical Aid Account to break even during calendar year 2011 and maintain the solvency of the account over the next five years.

ABOUT THE WORKER'S COMPENSATION ACCOUNTS

The state's Workers' Compensation Program provides medical and limited wage replacement coverage to workers who experience job-related injuries and illness.

- The Medical Aid Account pays for medical care and related services, including some vocational rehabilitation.
- The Accident Account pays non-medical claim costs such as wage replacement benefits, most vocational rehabilitation, disability pensions and survivor benefits.
- The Pension Reserve Account pays benefits to all permanently disabled pensioners including disabled employees of self-insured employers.

- The Supplemental Pension Account, the Second Injury Account and the Self-Insured Employer Overpayment Reimbursement Account are also part of the Worker's Compensation program.

The Workers' Compensation Program establishes claims payable liabilities (unpaid loss and loss adjustment expense liabilities) based on estimates of the cost of claims (including future claims adjustment expenses) reported but not resolved and injuries that have not been reported that will result in claims. The Department's Director sets premium rates after considering input from the Workers' Compensation Advisory Committee, the Governor, interest groups and the Department's actuaries. For calendar year 2010, the state's employers paid an average hourly premium rate of $0.564. Under state law, a portion of the total premium may be paid by employee contribution.

The state Investment Board invests the money in these accounts under policies and procedures designed to maximize return at a prudent level of risk. Eligible investments include U.S. equities, international equities, U.S. treasuries and government agencies, credit bonds, mortgage backed securities, asset backed securities and non-U.S. dollar bonds. Investment allocation targets are as follows:

Account	Fixed Income	Treasury Inflation Protection Securities	Equity
Accident	80%	10%	10%
Medical Aid	65%	20%	15%
Pension Reserve	80%	10%	10%

AUDIT OVERVIEW

We audited the Workers' Compensation financial statements. We also contracted with an actuarial firm to conduct actuarial assessments of the loss reserves in the Accident Account, Medical Aid Account and the Pension Reserve Account. In addition, the firm assessed the financial effect of the proposed 2011 rate increase on the actuarial solvency of these accounts, taking into consideration the risks inherent with insurance and the effect of the actuarial assumptions, discount rates, reserving, retrospective rating program, refunds and individual employer rate classes, as well as the standard accounting principles used for insurance underwriting purposes.

We selected the actuarial firm through a competitive solicitation of independent qualified firms. The leader of the actuarial team is a member of the American Academy of Actuaries, a Fellow of the Casualty Actuarial Society, and meets qualification standards for statements of actuarial opinion.

AUDIT RESULTS

Financial Statement Opinion

We issued an unqualified opinion concluding that the financial statements of the Workers' Compensation Program of the state of Washington for the fiscal year ended June 30, 2010, were fairly presented in accordance with generally accepted accounting principles. The financial statements can be seen at:
http://www.lni.wa.gov/ClaimsIns/Files/StateFundFinancial/2010GaapRpt.pdf

Actuarial Opinion on Loss Reserves

The Actuarial firm issued an opinion stating the reported loss and loss adjustment expense reserves are consistent with reserves computed in accordance with *Standards of Practice*, issued by the Actuarial Standards Board, and the reserves make a reasonable provision for all unpaid loss and loss adjustment expense obligations of the Workers' Compensation Program.

Assessment of the Financial Impact of the Proposed 2011 Rate Level

During the fiscal year ended June 30, 2010, the Accident Account's contingency reserve fell below zero. The combined contingency reserves of the Accident and Medical Aid accounts remained positive. The contingency reserve is the difference between the account's total assets and its total liabilities. For a typical insurance company, this value would be called surplus or equity. It is important to maintain adequate reserves to cover unexpected losses as well as shortfalls in premium and investment income.

Contingency Reserve (expressed in thousands) Presented under statutory accounting principles				
Account	June 30, 2007	June 30, 2008	June 30, 2009	June 30, 2010
Accident	$ 841,004	$ 776,052	$ 69,638	($358,125)
Medical Aid	$1,252,708	$ 825,894	$480,583	$539,335
Combined	**$2,093,712**	**$1,601,946**	**$550,221**	**$181,210**

The decline in the Accident Account reserves can be attributed to:

- The economic recession has caused less money to flow into the system due to fewer hours worked.
- Loss and loss adjustment expense liabilities in the Accident Account increased significantly during the fiscal year. The growing duration of time loss claims and frequency of pension awards has contributed to the increase.
- For the past three years premium rates have been insufficient to fund the system.

Under an emergency rule, the Department has proposed adopting new premium rates that will take effect January 1, 2011, and be effective for 120 days. Public hearings will be held before adopting a permanent rule. The Department proposes raising rates by 29.8 percent in the Accident Account to an average hourly premium rate of $0.339 and lowering rates by 10.3 percent in the Medical Aid Account to an average hourly premium rate of $0.184. The average workers' compensation insurance premiums would increase 12 percent or 6.5 cents per hour worked. Considering the 2011 proposed rate change, and assuming the Department will continue raising rates in 2012 and beyond consistent with long-term averages, the Actuarial firm believes it is unlikely the rate changes will be sufficient to keep the contingency reserve greater than zero in either account over the long term. The firm estimates:

- A 94.5 percent chance the Accident Account will remain insolvent over the next two years, 95.9 percent over the next three years and 96.4 percent over the next five years.

- A 21.7 percent chance the Medical Aid Account will become insolvent in two years, 52.9 percent within three years and 94.1 percent within five years.

Insolvency is defined as liabilities in excess of the value of assets. It is important to note that insolvency is not necessarily a key indicator of the accounts' ability to pay claims, to have sufficient cash or the Department's ability to liquidate invested assets to pay obligations over the next several years.

The Actuarial firm stated the probability that the accounts would not have sufficient cash and/or invested assets to pay benefits over the next 10 years is extremely low. However, over the longer term the accounts would run out of cash and/or invested assets without appropriate rate actions. The Actuarial firm's conclusions are based on a number of assumptions regarding future conditions and events. These are described in detail in the firm's report.

The Pension Reserve Account does not assess premiums. It is funded through contributions and transfers from the Accident Account and self-insurers. Typically, the system fully funds each pension annuity when the liability is transferred to the pension reserve account. Because of the way the Pension Reserve Account is financed, its solvency is guaranteed as long as the Accident Account and the self-insurance program remain solvent.

The Actuarial firm also calculated the rate level change that would be required for the accounts to break even. This is defined as the point in which zero profits are expected to be generated on all new policies written in calendar year 2011 and the account's contingency reserves remain unchanged.

The Actuarial firm estimates the 2011 rate increase necessary for the Accident Account to break even would range between 28.5 percent and 40.8 percent. The firm's "best" estimate is that a 34.8 percent rate increase would be necessary for the Accident Account to break even.

The Actuarial firm estimates the 2011 rate increase necessary for the Medical Aid Account to break even would range between 7.5 percent and 16.6 percent. The firm's "best" estimate is that an 11.8 percent rate increase would be necessary to break even.

Account	Actuarial firm's best estimate of the rate level change required to break-even	Department's proposed 2011 rate change
Accident	34.8%	29.8%
Medical Aid	11.8%	(10.3%)

The Department's proposed rate increase for the Accident account falls within the Actuarial firm's estimated reasonable range.

The Department's proposed rate decrease for the Medical Aid Account falls outside the Actuarial firm's reasonable range and will likely be inadequate to allow the Medical Aid Account to break even during calendar year 2011.

Findings and Recommendation

Contrary to state law (RCW 51.16.035), the Department has not proposed a premium rate necessary to maintain the actuarial solvency of the Accident Account in accordance with recognized insurance principles.

We recommend the Department adopt a premium rate necessary to maintain the actuarial solvency of the Accident Account in accordance with recognized insurance principles.

ABOUT THE STATE AUDITOR'S OFFICE

The State Auditor's Office is established in the state's Constitution and is part of the executive branch of state government. The State Auditor is elected by the citizens of Washington and serves four-year terms.

Our mission is to work in cooperation with our audit clients and citizens as an advocate for government accountability. As an elected agency, the State Auditor's Office has the independence necessary to objectively perform audits and investigations. Our audits are designed to comply with professional standards as well as to satisfy the requirements of federal, state, and local laws.

The State Auditor's Office employees are located around the state to deliver our services effectively and efficiently.

Our audits look at financial information and compliance with state, federal and local laws on the part of all local governments, including schools, and all state agencies, including institutions of higher education. In addition, we conduct performance audits of state agencies and local governments and fraud, whistleblower and citizen hotline investigations.

The results of our work are widely distributed through a variety of reports, which are available on our Web site and through our free, electronic subscription service. We continue to refine our reporting efforts to ensure the results of our audits are useful and understandable.

We take our role as partners in accountability seriously. We provide training and technical assistance to governments and have an extensive quality assurance program.

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